In the Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-970

C. JAMES MATHEWS AND JOYCE C. MATHEWS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole issue presented by the petition in this income tax case is whether purported rental payments, made by petitioner[1] pursuant to a gift and leaseback arrangement, were deductible as ordinary and necessary business expenses under Section 162(a)(3) of the Internal Revenue Code of 1954 (26 U.S.C.).

The relevant facts are as follows: Petitioner owns and operates a funeral home in St. Petersburg, Florida. Prior to November 1, 1961, petitioner owned the realty, comprising the funeral home building and the lot upon which it was located. On November 1, 1961, petitioner transferred the realty (in four equal undivided shares) to irrevocable trusts created on that date for the benefit of his four

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[1]"Petitioner" refers to C. James Mathews. Joyce C. Mathews is a party solely because she filed a joint return with her husband for the years at issue.

minor children. Petitioner's attorney was named trustee for each of the trusts. Each trust provided that it was to terminate ten years and one day after its creation, after which the corpus was to revert to petitioner[2] (Pet. App. B A-6 to A-7).

Prior to the transfer of the property to the trusts, a leaseback arrangement was agreed upon with the prospective trustee pursuant to which the realty was leased back to petitioner, who continued to operate his funeral home business thereon without interruption. On February 1, 1963, petitioner and the trustee entered into a new lease of the property which provided for an initial term of one year with the option given to petitioner to renew the lease from year to year for the duration of the trusts upon mutually agreeable terms. This lease, or renewals thereof, was in effect during the taxable periods (Pet. App. B A-7).

In accordance with the terms of the lease, petitioner paid approximately $14,000 as purported rental payments to the trusts during each of the years 1964, 1965, and 1966. These amounts were deducted by petitioner on his returns for those years as business expenses under Section 162(a)(3) of the Code (Pet. App. B A-7).

On audit, the Commissioner of Internal Revenue disallowed petitioner's claimed rental deductions. The Tax Court upheld the deductibility of the purported rental payments to the trusts (Pet. App. B A-11 to A-19). The court of appeals reversed. It held that the gift and leaseback transaction as a whole had no purpose other than to divert

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[2]Subsequently, on May 23, 1966, petitioner, in an attempt to avoid possible adverse tax consequences, transferred his reversionary interests in the trusts to a new irrevocable trust for the benefit of the children (Pet. App. B A-7).

petitioner's income to his children, and, therefore, the payments made in connection with the transaction were not allowable deductions under Section 162 (a)(3) (Pet. App. A A-1 to A-3).

In so holding, the court of appeals relied on its well-reasoned decision in *Van Zandt* v. *Commissioner*, 341 F.2d 440, certiorari denied, 392 U.S. 814, which was recently followed in *Perry* v. *United States*, 520 F.2d 235 (C.A. 4), certiorari denied, No. 75-625, January 12, 1976. The court rejected petitioner's contention that its earlier decision in *Van Zandt* was distinguishable because the initial lease there covered the entire term of the trust, whereas the initial lease in this case had a one-year term and the subsequent lease had a year-to-year option to renew. It pointed out (Pet. App. A A-3) that, as a practical matter, the distinction was without a difference. It further noted that petitioner's effective control of the property for the duration of the trusts was never in doubt, since the trustee had a clear understanding with petitioner prior to the transfer of the property to the trusts that the property was to be leased back to petitioner so as to permit the continued and uninterrupted operation of petitioner's funeral home business (Pet. App. B A-7; R. 44).[3]

The decision in *Skemp* v. *Commissioner*, 168 F.2d 598 (C.A. 7), relied upon by petitioner (Pet. 5), is not to the contrary. As the Fourth Circuit in *Perry* and the Fifth Circuit in *Van Zandt* (341 F.2d at 442) both noted, *Skemp* was a case in which more property was conveyed to the trustee than was leased back to the grantor-taxpayer for his use. Under these circumstances, there may have been a proper business purpose for the gift and leaseback transaction and

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[3]"R." refers to the record appendix filed in the court of appeals.

hence the trust apparently was not solely a device for the diversion of the taxpayer's earnings to his wife and children. Furthermore, in *Skemp* the grantor retained no reversionary interest in the trust property.[4]

Contrary to petitioner's assertion (Pet. 5-6), the decision below does not conflict with *Brooke* v. *United States*, 468 F.2d 1155 (C.A. 9), or *Brown* v. *Commissioner*, 180 F.2d 926 (C.A. 3), certiorari denied, 340 U.S. 814. Unlike this case, *Brooke* involved an absolute outright conveyance to the taxpayer's children, and not a trust for a term of years. *Brown* involved the transfer by the taxpayer of coal-producing property and a railroad siding to a trust for the taxpayer's children for 22 years. While petitioner's arrangement with the trustee in this case insured that he would retain effective control over the transferred property during the terms of the trusts, the taxpayer in *Brown* leased back the coal property and the railroad siding for only five and ten years respectively. Moreover, unlike petitioner, the taxpayer in *Brown* retained no reversionary interest in the trust property.

In light of these factual differences, the treatment of the trust and leaseback as separate transactions in *Brown* does not conflict with the decision below. As the Fifth Circuit observed in *Van Zandt* (341 F.2d at 444): "* * * factors such as the short term of the trust, reversion to the settlors, predetermination of the right to possession of the property, and the like * * * bear heavily on the element of business purpose."

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[4]Here, the Commissioner disallowed petitioner's claimed rental deductions only with respect to the period during which he retained reversionary interests in the trusts. The deductions were not challenged following petitioner's conveyance of those interests on May 23, 1966 (Pet. App. B A-8).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

FEBRUARY 1976.